

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

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FISCAL IMPACT STATEMENT

LS 8066

BILL NUMBER: HB 1867

DATE PREPARED: Feb 4, 1999

BILL AMENDED:

SUBJECT: Internal Revenue Code Update.

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FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: This bill updates the references to the Internal Revenue Code.

Effective Date: January 1, 1999 (retroactive).

Explanation of State Expenditures:

Explanation of State Revenues: (Revised) This bill updates the references to the Internal Revenue Code (IRC) in the current statute to reflect changes made in the IRC before January 1, 1999. The current statute references the IRC effective January 1, 1998. During 1998, the Internal Revenue Service Restructuring and Reform Act of 1998 (HR 2676) was enacted which made a number of federal tax changes that could affect Indiana adjusted gross income calculations (AGI) and individual income tax revenue. The Tax and Trade Relief Extension Act of 1998 (Division J of HR 4328, The Omnibus Consolidated and Emergency Supplemental Appropriations Act,) P.L. 105-277 (1998) also contains a few provisions which will affect individual AGI.

Information from the Federal Tax Administrators (FTA) and the Joint Committee on Taxation (JCT) have been reviewed in order to estimate the impact of various provisions in this Act. The following provisions have been identified which will have an impact on state revenue due to changes in tax administration or Indiana adjusted gross income (AGI) with the change in the IRC reference date of January 1, 1999. The estimated tax impacts cited below are based on information from the JCT.

Refund Offset: HR 2676 allows states to participate in the federal refund offset program to recapture income tax debts. This program will now cover state and local income tax delinquencies administered by the state. State delinquencies submitted for the federal refund offset will only be granted after other eligible debt owed by the taxpayer for federal taxes, overdue child support, or student loans are satisfied. The state must notify the taxpayer via certified mail that the debt is going to be referred for federal offset. The program will apply

to refunds issued after December 31, 1999. As of October 6, 1998, state tax delinquencies for individual income taxes equaled \$3.5 M. Not all of this debt would be collectible because specific conditions must be met for participation in the offset program. This provision will increase income tax collections by an indeterminable amount beginning in FY 2001.

Roth IRA: Beginning in the 2005 tax year, the minimum required distributions of IRAs are not included in the definition of AGI for the purpose of determining eligibility to convert an IRA to a Roth IRA. Under the present law, distributions are includible in gross income in the year of distribution. The Taxpayer Relief Act of 1997 allowed taxpayers to convert deductible or nondeductible IRAs into a Roth IRA but eligibility was capped for taxpayers with an AGI under \$100,000. Distributions were also part of the calculation of AGI. In essence the change created in HR 2676 raises the income eligibility for taxpayers to make use of the Roth IRAs. This change could potentially increase state and federal revenue on a one-time basis for tax year 2005 or FY 2006.

Employer Deduction for Vacation and Severance Pay: HR 2676 includes a provision that employer deductions made for vacation and severance pay may not be made until they are actually received by the employee. This provision is intended to overrule the *Schmidt Banking* Tax Court decision which allowed the employer a deduction for accrued vacation and severance pay liabilities since they purchased an irrevocable letter of credit. The Court held that the letter of credit constituted payment of vacation and severance pay since it was purchased within the 2 ½ month period so that the payment was not considered deferred compensation and was allowable as a deduction for the employer. HR 2676 clarified that many arrangements, in addition to the letter of credit approach used in *Schmidt Banking*, do not constitute actual receipt by employees.

Since vacation and severance pay deductions will not be eligible until these payments are actually received by the employee, the JCT anticipates an increase in the AGI of employers. This provision is effective for taxable years beginning in 1998.

Estimated state impact: + \$2.1 M in FY 99, + \$2.6 M in FY 2000, + \$1.6 M in FY 2001

Meal Deduction: HR 2676 allows employers to take an income tax deduction for meals furnished to employees at a place of business if the meals are provided for the convenience of the employer and are furnished to more than one-half of the employees. Employees do not have to include the value of the meals as income. This provision will decrease employers adjusted gross income by the amount of the allowable deduction and have a minimal impact on revenue collections.

Mark-to-Market Receivables: Dealers in nonfinancial goods and services will not be able to elect “mark-to-market” accounting rules to deduct receivables as a loss. This provision will increase the AGI of these taxpayers.

Estimated state impact: + \$670,000 in FY 99, + \$1.24 M in FY 2000, + \$1.02 M in FY 2001

Income Averaging for Farmers: The three year income averaging provision for individuals who have taxable income from the trade or business of farming was made permanent. This provision was set to expire December 31, 2000.

Estimated state impact: Minimal loss beginning in FY 2001.

Net Operating Loss Carryback Period for Farmers: Currently taxpayers engaged in farming business were allowed to carry back a net operating loss (the amount by which business deductions exceeded business gross income) for two years and carry forward the loss for 20 years to offset taxable income in those years. The carry back provision was extended to a five year period effective for tax years beginning after December 31, 1997.

Estimated state impact: Minimal Loss beginning in FY 99.

Self-Employed Health Insurance Deduction: This deduction was recently increased in the 1996 Health Insurance Portability Act, Public Law 104-191, the Taxpayer Relief Act of 1997 (H.R. 2041) and the Tax and Trade Relief Extension Act of 1998 (Division J of HR 4328, The Omnibus Consolidated and Emergency Supplemental Appropriations Act,) P.L. 105-277 (1998). The percentage of the federal deductions are outlined in the following table.

Tax Year	1996 Health Insurance Portability Act	1997 Taxpayer Relief Act	P.L. 105-277 1998
1999	45%	NC	60%
2000	45%	50%	60%
2001	45%	50%	60%
2002	45%	60%	70%
2003	50%	80%	100%
2004	60%	80%	100%
2005	70%	80%	100%
2006	80%	90%	100%
2007	80%	100%	100%

Estimated state impact: (\$500,000) in FY 99, (\$900,000) in FY 2000, (\$700,000) in FY 2001

State Volume Limits on Private Activity Tax-Exempt Bonds: Current law restricts the volume of tax-exempt private activity bonds that States and local governments may issue to the greater of \$50 per resident of the state or \$150 M. This volume limit is increase to the greater of \$55 per resident or \$165 M in CY 2003, \$60 per resident or \$180 M in CY 2004, \$65 per resident or \$195 M in CY 2005 and \$70 per resident or \$210 M in CY 2006.

Estimated state impact: Revenue loss beginning in FY 2003 and years after.

Regulated Invested Companies (RICs) and Real Estate Investment Trusts (REITs): Effective for distributions made after May 21, 1998, any amount of which a liquidating RIC or REIT may take as a deduction for dividends paid with respect to an otherwise tax-free liquidating distribution to a 80-percent corporate owner is now includible as income for the recipient corporation. This amount is treated as a dividend received from the RIC or REIT. If banks operating in Indiana were using this mechanism, there could be a minimal increase in financial institutions tax revenue beginning in FY 99.

Tax Treatment of Prizes and Awards: The principle of constructive receipt is eliminated for the payment of prizes and awards if the winner elects an option of receiving an annuity instead of receiving a lump-sum

distribution. Currently the taxpayer must pay taxes on the entire prize even if they elect to receive an annuity option. This change will allow the taxpayer to pay taxes only on the amount received annually and will spread the amount of taxes paid over the payment of the annuity instead of the first year. Depending on the election of the taxpayer for large prizes, this provision will spread out the payment of taxes versus the state receiving all the taxes in the first year. This could result in the reduction in revenue beginning in FY 2000.

A summary of the above provisions follows (in millions):

Provision	FY 99	FY 2000	FY 2001
Refund Offset			positive
Roth IRA (effects FY 2006)			
Employer vacation & severance pay	2.1	2.6	1.6
Meal deductions	Minimal Loss	Minimal Loss	Minimal Loss
Mark-to-Market	.7	1.2	1.0
Income averaging for Farmers			Minimal Loss
NOL Carryback for Farmers	Minimal Loss	Minimal Loss	Minimal Loss
Self-employed health insurance deduct.	(.5)	(.9)	(.7)
Vol. Limits-Tax-Exempt bonds (FY 2003)			
RICs & REITS liquidating distributions	Potential Incr	Potential Incr	Potential Incr
Tax treatment of Prizes & Awards	Minimal Loss	Minimal Loss	Minimal Loss
Net Impact (millions)	2.30	2.90	1.90

The Internal Revenue Service Restructuring and Reform Act of 1998 (HR 2676) also made a number of federal tax changes that could affect Indiana state tax revenue even without an update to the Indiana Code. However, taxpayers would have to recalculate income and capital gains for purposes of determining Indiana adjusted gross income based on the 1998 Internal Revenue Code if Indiana does not update to the 1999 Internal Revenue Code. A number of the changes regarding capital gains which could affect Indiana taxable income are described below.

Capital Gains: The Taxpayer Relief Act of 1997 cut the tax rates of capital gains for investments held for at least 18 months. The rates were reduced from 28% to 20% and to 10% for taxpayers in the 15% tax bracket. This change created three different holding periods and three different maximum tax rates. The current law also taxes capital gains on investments held from 12 to 18 months at a maximum rate of 28%, and capital gains on investments held for less than 12 months are taxed at the ordinary income tax rate of the individual.

HR2676-1998 lowers the holding period from 18 months to 12 months for investments to be eligible for the 20% capital gains tax rate. This change simplifies the capital gains tax structure and creates only two, instead of three, holding periods and rate structures. Federal estimates from the JCT suggest that this change will increase income generated from capital gains of investments sold after the 12-month holding period.

The Taxpayer Relief Act of 1997 also allowed exclusions of capital gains on the sale of a principal residence up to \$250,000 for a single taxpayer and \$500,000 for married couples regardless of whether the gains are

rolled over into another residence. However the taxpayer must have lived in the residence for at least two years. A partial exclusion was allowed if the taxpayer owned the residence for less than two years if they were forced to move due to a job transfer. This exclusion was based on how long the homeowners actually lived in the house.

HR 2676 provides a “technical correction” to clarify the intent of the partial exclusion. The Internal Revenue Service had interpreted the pro-rated basis to be applied to the actual gain made on the sale of the home. HR 2676 clarifies that the pro-rated basis is applied to the amount of the exclusion. For example, if a taxpayer lived in a home for one year and made a gain of \$100,000, the 50% pro-rated exclusion would apply to the limit of \$250,000 (\$125,000) versus 50% of the gain made on the home (\$50,000). In this case the taxpayer would be able to exclude the full amount of the gain since the pro-rated exclusion would be \$125,000 versus \$50,000 as originally interpreted by the IRS.

Estimated state impact: + \$1.56 M in FY 99, + \$520,000 in FY 2000

Explanation of Local Expenditures:

Explanation of Local Revenues: Those counties that have a local option income tax may see a net increase in revenue due to the above provisions.

State Agencies Affected: Department of Revenue.

Local Agencies Affected: Counties with a local option income tax.

Information Sources: Federal Tax Administrators; the Joint Committee on Taxation .